Insolvency & Financial Restructuring

RECENT DEVELOPMENTS OF IMPORTANCE

ANDREW KENT
TUSHARA WEERASOORIYA
McMillan Binch Mendelsohn LLP

Introduction

Insolvency law in Canada is governed by two main federal statutes: the *Bankruptcy and Insolvency Act* (the "BIA") and the *Companies' Creditors Arrangement Act* (the "CCAA"). The latter functions as Canada's primary equivalent of Chapter 11 of *the United States Bankruptcy Code*, while the former contains both an equivalent to Chapter 7 and an abbreviated, simplified restructuring scheme used primarily in smaller cases. Unlike the United States, the Canadian federal government's interest in bankruptcy law reform has until recently been limited. Consequently, the BIA and CCAA (enacted in the Depression era) are antiquated statutes and have sometimes proven to be inadequate in handling issues arising within the modern restructuring climate.

This lack of statutory guidance led trial judges, over time, to take an increasingly activist approach to the administration of restructuring cases through the use of judicial discretion, and an increasingly broad interpretation of the court's "inherent jurisdiction." Indeed, by the late 1990s Justice Farley, a strong proponent of the "inherent jurisdiction" approach, had become the dominant judge in Ontario, the biggest commercial court in Canada. As a result, the administration of restructuring cases became less rule-oriented and instead became more pragmatically focused on achieving a plan or deal, often to the detriment of the substantive legal rights of particular stakeholder groups.

It appears, however, that the pendulum may be swinging toward a more structured approach to Canadian insolvency law. The recent retirement of Justice Farley in March of this year, coupled with certain legislative and judicial developments (discussed in more detail below) may herald a shift away from reliance on inherent jurisdiction toward a more black-letter law approach to insolvency law in Canada.

Law Reform Efforts

In November of 2005, the Canadian parliament passed the *Act to establish the* Wage Earner Protection Act, *to amend the* Bankruptcy and Insolvency Act *and* Companies' Creditors Arrangement Act *and to make consequential amendments to other acts* (the "Reform Act"). As its name suggests, the Reform Act addresses certain perceived injustices to workers under current restructuring law. However, the bulk of the Reform Act amendments involve an effort to bring more consistency to the restructuring practice across the provincial jurisdictions in Canada.

Restructuring law and practice in Canada developed incrementally through the exercise of judicial discretion and inherent jurisdiction. This approach, over time, led to the adoption of forms of relief familiar to U.S. insolvency professionals, such as DIP financing, the retention or disclaimer of executory contracts and sales of businesses during a restructuring proceeding. However, the absence of clear statutory authority for this relief or any rules governing the granting of relief resulted in a lack of predictability in restructuring practice.

The content of the Reform Act, in many ways, represents a policy shift away from ad hoc restructuring practices, toward a more structured and principle-based approach to insolvency law. Indeed, many of the "reforms" are the simple codification of practices developed by some bankruptcy courts over the last ten years. For example, the Reform Act codifies the availability of both DIP and directors' priority charges under both the BIA and the CCAA, forms of relief that have been increasingly available in Canada over time. Other notable aspects of the Reform Act include the creation of a scheme for disclaiming or retaining executory contracts during a restructuring proceeding, and also express statutory authority for the Canadian equivalent of s. 363 sales processes. The Reform Act also implements a scheme for recognition of foreign insolvency proceedings based on the UNCITRAL model, which is conceptually similar to Chapter 15 of the *United States Bankruptcy Code*.[1]

Although not nearly as comprehensive as the *United States Bankruptcy Code*, the reforms go a significant way toward changing the basis for relief in Canadian restructurings from judge-made law to statute-based law. Nevertheless, while the Reform Act contains many necessary amendments and clarifications to insolvency law, it is by no means complete, and insolvency practitioners have noted numerous technical deficiencies arising from the current draft.[2]

As a result, the legislation has yet to be proclaimed into force, leaving insolvency practitioners in something of a holding pattern. For example, an area of technical concern for insolvency professionals has been the treatment of insolvent income trusts because trusts in general may not qualify for relief under existing bankruptcy legislation. The Reform Act was intended to close this gap in the legislation. In the absence of reforms, formal restructurings of income trusts will likely include only the underlying entities, rather than the trusts themselves.

In a number of respects, the Reform Act codifies practices that were developed from U.S. principles and therefore brings the Canadian restructuring system somewhat closer to the U.S. system. However, in some aspects its proclamation would widen the gulf between the two systems. In particular, the Reform Act will provide greater protection for union contracts. It will basically oust any jurisdiction of the bankruptcy court to terminate union contracts and require ongoing compliance with union contracts during a restructuring proceeding. In substance, union contracts will only be modified during a restructuring process through normal collective bargaining. As a result, it is anticipated that the Reform Act will increase the odds of unionized businesses being liquidated rather than being reorganized or sold as going concerns. However, restructurings involving unionized businesses remain a possibility where the union proves to be very responsive at the outset of the case, as was the recent restructuring of a small public company called Roman Corp.

Recent Case Law

Two relatively recent appellate court decisions also materially restrict the use of inherent jurisdiction by bankruptcy judges. One, a decision of the Supreme Court of Canada, stands for the proposition that even without the enactment of the Reform Act certain employment matters are to be dealt with by labor law tribunals rather than by the bankruptcy court. The other, a decision of the Ontario Court of Appeal,

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restricts the authority of the bankruptcy court to deal with the corporate governance of a debtor. The reasoning of this latter decision, in particular, may severely limit the future use by Canadian bankruptcy courts of inherent jurisdiction.

TCT Logistics

In the recent decision of the Supreme Court of Canada in *GMAC Commercial Credit Corp. and TCT Logistics et al v. Wood & Allied Workers of Canada Local 700*[3] ("*TCT Logistics*"), the Court was asked to consider whether a receiver, appointed on the application of a secured creditor to affect a going concern sale of the business of TCT Logistics, should be at risk of being considered a "successor employer." Under Ontario labor and employment law, designation as a "successor employer" exposes a receiver to liability for unpaid wages, severance and termination pay and underfunded pensions, and binds a receiver to the terms of any collective bargaining agreement.

The case arose as a result of the practice in the 1990s of drafting receivership orders in a manner designed to restrict the potential liability of receivers. In particular, receivership orders commonly contained a provision specifically insulating receivers from liability as successor employers. The appointment order in *TCT Logistics* contained such a provision.

At its heart, the issue on appeal before the Supreme Court was a procedural determination of the proper forum for determinations of successor employer liability. Taking a strict interpretive approach to the case, the Supreme Court concluded that successor employer determinations were beyond the jurisdiction of the bankruptcy court. The Court noted that the statutory parameters of the BIA (under which the receiver had been appointed), though sufficiently flexible to authorize a wide range of conduct on the part of the receiver, are not open-ended. Successor employer determinations are clearly within the scope of provincial labor and employment legislation.

The Supreme Court appears to have conclusively addressed the legal issue on appeal in *TCT Logistics*, and in doing so has signaled a retrenchment of the bankruptcy court's expansive approach to its own jurisdiction. However, the decision adds uncertainty to the scope of liability faced by a receiver. In practical terms, the effect of the decision will be to discourage the use of receivers to attempt to sell businesses on a going concern basis, and to increase the chances of shutdown liquidations in marginal situations.

The appointment of receivers is generally considered a secured creditor remedy and, as such, secured creditors have often provided receivers with indemnities for liabilities incurred in the course of administering the receivership. Secured creditors are unlikely to have much of an appetite for backstopping the potential liability, which in some cases could be significant, created by *TCT Logistics*. In particular, it will become progressively more difficult to appoint receivers to operate companies that have a unionized work force.

As an alternative to receiverships, we may well see a shift toward creditor-initiated restructuring proceedings as a means of ensuring that any employment-related liability remains that of the debtor. A single creditor has standing to make an application to place a debtor under CCAA protection.

Stelco Inc. (Re)[4]

The Supreme Court of Canada's decision in *TCT Logistics* was preceded by an important decision of the Ontario Court of Appeal that may have limited the inherent jurisdiction of the bankruptcy court on a more general basis. The decision was made in the course of the restructuring of a steel producer called Stelco Inc. ("Stelco"), which was among the most high-profile Canadian restructurings of the last two years.

Stelco obtained protection from its creditors under the CCAA on January 29, 2004. From the outset, Justice Farley took on the role of supervising judge of the Stelco restructuring. At the time the appeal arose, the Stelco restructuring was focused on a court-approved capital raising or sale process. During the bidding process, the board of directors of Stelco made two new, controversial appointments to the board. The new directors were principals of two investment companies that had, during the restructuring process, acquired approximately 20% of the company's common shares. Several stakeholder groups objected to the appointments on the grounds that they offered the equity holders an unfair advantage within the auction process. Justice Farley agreed, declaring the appointments to be of no force and effect and removing the directors from the board.

The court of appeal overturned Justice Farley's decision. As in *TCT Logistics*, the court based its decision on principles of statutory interpretation. In CCAA restructurings, the supervisory role of the trial judge is derived from section 11 of the statute, which provides the court with a discretionary power to stay, restrain and prohibit actions, suits or proceedings against the company. Over the years, trial judges have read into this section a broad and considerably flexible discretion to realize pragmatic solutions within the restructuring context. In this case, however, the court of appeal found that the discretion under section 11 was "not open-ended and unfettered" and that the section did not provide the trial court with the authority to remove directors, outside of the express provisions of Canadian and provincial corporations legislation. Again, the decision in *Stelco Inc. (Re)* signifies a move toward a more rule-focused application of insolvency laws.

The decision in *Stelco Inc. (Re)* also appears to significantly narrow the role of a supervising judge in the restructuring context. Indeed, the court described the role of the supervising judge as maintaining the status quo and acting as a "referee" while the company and its creditors attempt to reach a compromise through negotiating a restructuring plan. The court of appeal discouraged trial judges from interfering with the debtor's efforts to reorganize. This particular understanding of a trial judge's role in the restructuring process mirrors CCAA practice as it was in the early 1990s. However, since then, the supervising judge's role has gone far beyond that of maintaining the status quo. Trial judges now commonly authorize the debtor to take many important steps, including possibly the sale of the debtor's entire business, that fundamentally alter the status quo long before any negotiations with creditors take place.

One interpretation of the court of appeal's decision is to say that the bankruptcy courts should continue to empower the debtor, without supervising the debtor or otherwise taking any responsibility to ensure that the extraordinary powers given to the debtor are used appropriately. In Canada, this may be particularly problem-

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atic because of other differences between the Canadian and U.S. systems. Firstly, the CCAA does not require the creation of creditors' committees to balance the debtor-driven process. Although informal committees of creditors have played roles in Canadian restructurings, their powers are much more limited than are those of U.S. creditors' committees. Secondly, it is common for a debtor to use its existing law firm as bankruptcy counsel. In fact, consistent with that common practice, in the Stelco case the debtor's primary business law firm acted as restructuring counsel, and several of the debtor's board members were or had been partners of the law firm. These Canadian practices remove some of the potential checks and balances that exist under U.S. restructuring practice.

Conclusion

The trend away from inherent jurisdiction as the basis for insolvency law and practice in Canada may well create a more predictable restructuring regime. However, the potential removal of the bankruptcy court as an effective check on the powers exercised by a debtor, coupled with the current statutory lacuna, has left debtor companies with relatively unrestricted, but ill-defined, powers within the restructuring process. It remains to be seen how those powers will be used. ■

1 For a detailed discussion of the Reform Act, see E. Vallieres & N. Scheib, "Reform Restructuring Legislation in Canada: Evolution or Revolution?" J. Corp. Renewal, April 2006.
2 See A. J. F. Kent & A. C. Maerov, "Flawed Canadian Insolvency Law Reform Enacted ?," at www.mcmillanbinch.com.
3 2006 S.C.C. 35.
4 (2005) 75 O.R. (3d) 5 (Ont. C.A.).

Andrew J. F. Kent, *McMillan Binch Mendelsohn LLP*
Tel: (416) 865-7160 • Fax: (416) 865-7048 • E-mail: andrew.kent@mcmbm.com

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Tushara Weerasooriya, *McMillan Binch Mendelsohn LLP*
Tel: (416) 865-7262 • Fax: (416) 865-7048 • E-mail: tushara.weerasooriya@mcmbm.com

Tushara is an associate in the firm's Corporate Restructuring Group. She joined McMillan Binch Mendelsohn in 2003 as a summer student and completed her articles with the firm in 2005. Tushara's practice involves all aspects of insolvency law including reorganizations, bankruptcies, receiverships and cross-border insolvencies. She has also provided legal services in a broad range of commercial matters relating to insurance law, securities regulation and conflicts of law. Member of the CBA. Queens University, B.Sc.H (first class), 2000. Osgoode Hall Law School, LL.B., 2004. Ontario Bar, 2005.

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